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The Manufacturers Hanover
Economic Report

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Economic Policy Questions

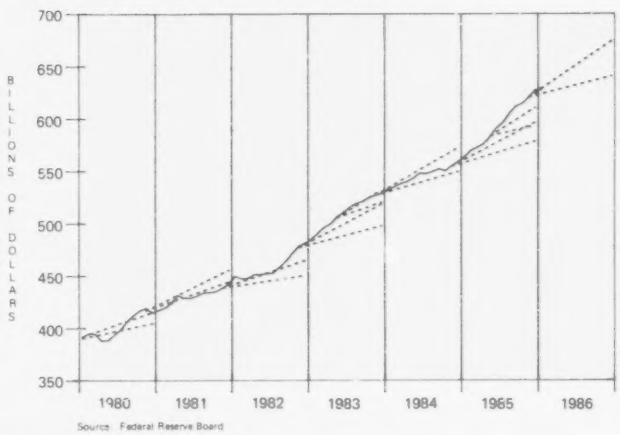
At present, policymakers are grappling with a number of economic issues. How these are resolved will have a significant bearing—not only on the outlook for the near-term, but, conceivably, for several years to come. At the top of the list is monetary policy and the extent to which the Federal Reserve, which just recently cut its discount rate, should ease even further. Right behind it is the question of the Federal government's budget, and how much red ink it will run—not just in the current fiscal year, but over the balance of this decade. It goes without saying that these two policy questions are very much intertwined, with each affecting the other to a considerable degree.

Monetary Policy: To Ease Or Not To Ease

When the Fed cut its discount rate on March 7th from 7½ percent to seven percent, it was responding to a variety of developments, some arguing for ease and some arguing against it. Looking back, it would appear that the events that led directly to the Fed's decision were similar moves on the part of Japan and West Germany. The Bundesbank cut its discount rate to 3½ percent from four percent, a development that was followed in short order by a cut in the Bank of Japan's discount rate from 4½ percent to four percent.

These central banks, and the others that followed, doubtless responded to signals—both overt and covert—that Federal Reserve Chairman Paul A. Volcker had sent during the previous few weeks. For example, in his testimony before the House Committee on Banking, Finance and Urban Affairs in February, Mr. Volcker pointed out that economic conditions abroad were not all that strong. While he did acknowledge signs of somewhat stronger growth in Germany than elsewhere in continental Europe, he did question "whether that growth will in fact be strong enough to reduce appreciably continued high levels of unemployment, now averaging more than ten percent for the continent as a whole." He also noted that in Japan, where unemployment is historically at much lower levels, "growth by these same historical standards is sluggish, with the appreciation of the yen itself a restraining factor."

CHART I
MONEY SUPPLY – M1 (LINE) VS. FEDERAL RESERVE'S GROWTH TARGETS (DOT)



Source: Federal Reserve Board

By cutting their key interest rates, these countries took an important step toward enhancing their own growth prospects. This is good in and of itself, to be sure. However, it will also help us to reduce our trade deficit by strengthening foreign markets for our goods. In spite of the roughly 30 percent drop in the value of the U.S. dollar in foreign exchange markets since February 1985, our trade deficit has not yet begun to shrink. It will soon, and when it does it will be a plus for domestic producers of goods, although the accompanying reduced inflow of funds to the U.S. might lead to renewed interest rate pressures in our financial markets, because of Washington's huge budget deficits and its accompanying sizable borrowing needs.

The decision to cut the discount rate, thus signaling to the markets that the Fed has eased a touch, was not easy to come by—cuts in foreign discount rates, notwithstanding. This is because of the many uncer-

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tainties that continue to characterize the economic scene. The labor force figures, themselves, typify these uncertainties. Although nonfarm payrolls in February rose 226,000 after rising 421,000 in January and 285,000 in December, the widely-watched unemployment rate shot up 0.6 percentage points to 7.3 percent of the work force in February, marking the highest civilian jobless rate since the 7.4 percent posted in January 1985. What is more, total civilian employment in February fell 394,000 after rising 749,000 in the previous month.

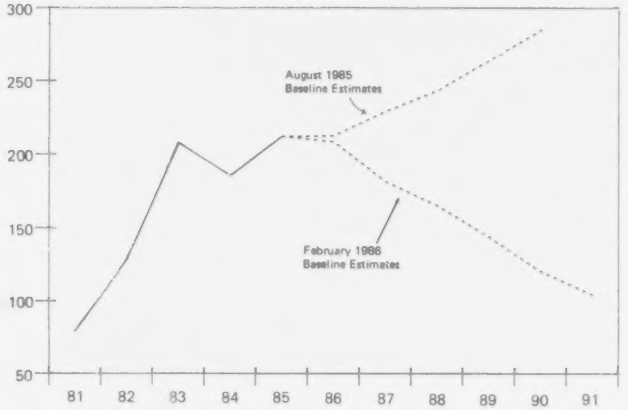
New car sales, stimulated by dealer financing incentives, perked up in February but overall retail sales appear to have been weak both in January and in February. Personal incomes declined 0.1 percent in January, dragging consumption down by 0.4 percent, although both rose strongly in December. The Commerce Department's index of leading economic indicators declined 0.6 percent in January—but it rose faster in December than the government originally thought. There was a solid gain in construction expenditures in January, most of it occurring in residential construction, and the rise in single-family home sales in January coupled with recent declines in mortgage rates, argues for further strength in this sector. Meanwhile, the money supply has been growing rapidly—not only in 1985, but stretching back to 1982 (Chart I).

For all of their declines, interest rates adjusted for inflation are still high compared with historical experience. After subtracting four percent year-over-year inflation from the rate that the commercial banks charge their biggest and best customers, nine percent, one is left with a five percent real rate. This is down from the almost seven percent real rate of ten months ago, but it is still about twice as high as the highest real bank rate posted during the 1970s. The same may be said for long-term rates: a new-issue AA utility bond currently yields about nine percent. When subtracting the rate of inflation, one comes up with a real interest rate that is still well above the highest rate of the 1970s.

In addition, while it is nice to see prices going up at a slow clip, there are many sectors both here and abroad where prices are actually falling. From a consumer's point of view, declining prices may be fine. However, a seller would tend to view falling prices as hazardous to his wealth—an opinion that would no doubt be shared by his banker. When you combine this with the obvious pluses of faster economic growth and the still-high level of real interest rates, you might conclude that further declines in interest rates would seem to be in store. From here, any further downward movement in interest rates in the United States would seem to depend on a variety of developments, among them the next run of economic statistics, what happens to the value of the dollar in foreign exchange markets, the direction of oil prices, and, perhaps most important, the outlook for Washington's budget deficit.

Prospects for reductions in the budget deficit would seem to argue for additional Fed ease to compensate for the tightening up of fiscal policy that a cut in the budget deficit obviously implies. And since easier money tends to require a longer period of time to affect the economy than fiscal restraint, proponents of further monetary ease are suggesting that the Fed should waste no time in doing so. On the other hand, a Federal court recently declared a key portion of the Gramm-Rudman-Hollings Deficit Reduction Act unconstitutional, and if the Supreme Court upholds this decision, it could call into question the Government's long-range plan to eliminate the deficit. At the same time, however, the Congressional Budget Office (CBO) recently came out with a revised prediction for the budget deficit over the balance of this decade which is nothing short of astounding. Instead of ballooning up to nearly $300 billion by 1990, as was projected as recently as last August, the deficit is now expected to fall to $100 billion by 1991—even if no further steps are taken to cut it along the lines of Gramm-Rudman.

CHART II
ACTUAL (LINE) VS. PROJECTED (DOT) FEDERAL BUDGET DEFICIT
(FISCAL YEARS, BILLIONS OF DOLLARS)



Sources: Economic Report of the President; Congressional Budget Office

The Deficit: Changing Minds

When Chairman Volcker said last month that the Congress had taken action to improve prospects for declining Federal deficits in the years ahead, I doubt that he had in mind the astonishing turnabout by the Congressional Budget Office. As recently as last August, CBO was projecting budget deficits rising as far as the eye can see. Chart II shows that CBO projected that the budget deficit by 1990 would reach nearly $300 billion, reaffirming the projection it made six months earlier, in February 1985. For its part, the Office of Management and Budget (OMB), an arm of the

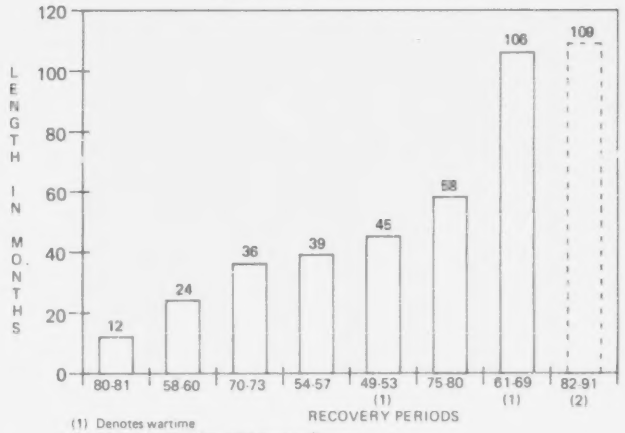
Administration, projected a string of deficits well over $200 billion a year. What is more, since both sets of projections assumed continued economic growth over the balance of a decade—an unprecedented development in postwar peacetime history—alternative projections were made suggesting what could happen to the deficit if a recession were to occur sometime between now and 1990. CBO estimated that such a downturn could push the deficit above $400 billion!

No doubt galvanized by these dire predictions, the Congress in December passed legislation calling for a steady reduction in the budget deficit to the point where it would be eliminated entirely by 1991. Known as the Gramm-Rudman-Hollings Deficit Reduction bill, it was promptly signed into law by President Reagan, in spite of concerns about how much spending would have to be trimmed and/or revenues enhanced in order to meet the law's targets. Congress was told by some economists that this law, by mandating drastic cuts in the Federal budget with the explicit purpose of reducing a string of $200 billion deficits to zero by 1991, would have no rival "save perhaps the infamous Smoot-Hawley tariff of 1929." Others anticipated that by cutting the deficit to zero in six years without offsetting stimulus, the government "would bring the economy to a grinding halt and push the unemployment rate back to double digits in short order."

Just like in the old-time movies, when the heroine was about to be run over by a speeding railroad train, only to be snatched up at the last minute by the Good Guy in the White Hat, along comes the Congressional Budget Office with its revised forecast for the deficit. Instead of projecting $200 billion deficits as far as the eye can see, not to mention its own $300 billion worth of red ink by the end of the decade, CBO now thinks that the deficit will shrink to around $100 billion by 1991—even without the Gramm-Rudman-mandated budget cuts. In view of this, one has to wonder whether Gramm-Rudman would have been passed and signed into law had this been the budget outlook. For that matter, one might question whether the Congress and the President will feel the need to slash the deficit if the Supreme Court, as is widely expected, upholds the lower court ruling on Gramm-Rudman and provides an "out".

To be sure, the difference between last year's long-range budget projections and this year's reflects some substantive developments. Indeed, one is the passage of the Gramm-Rudman law, itself, which has already eaten into Federal spending during the current fiscal year, thus lowering the base for future projections. Another deals with interest costs. Interest rates have come down much faster than either budget agency expected, and the result is $51 billion less interest expense by 1990. Of course, keeping interest rates down assumes that the commands of Gramm-Rudman will be followed—hardly a sure thing. The big reductions are in the defense area. Congress last year made a sizable cut in President Reagan's defense budget which he grudgingly accepted. The end result is a lowering of projected defense outlays by $56 billion in 1990. Nondefense discretionary spending is now projected to be $15 billion lower in 1990. Adding these and other changes together cuts the projected deficit for 1990 by $164.5 billion.

CHART III
COMPARING POSTWAR RECOVERIES

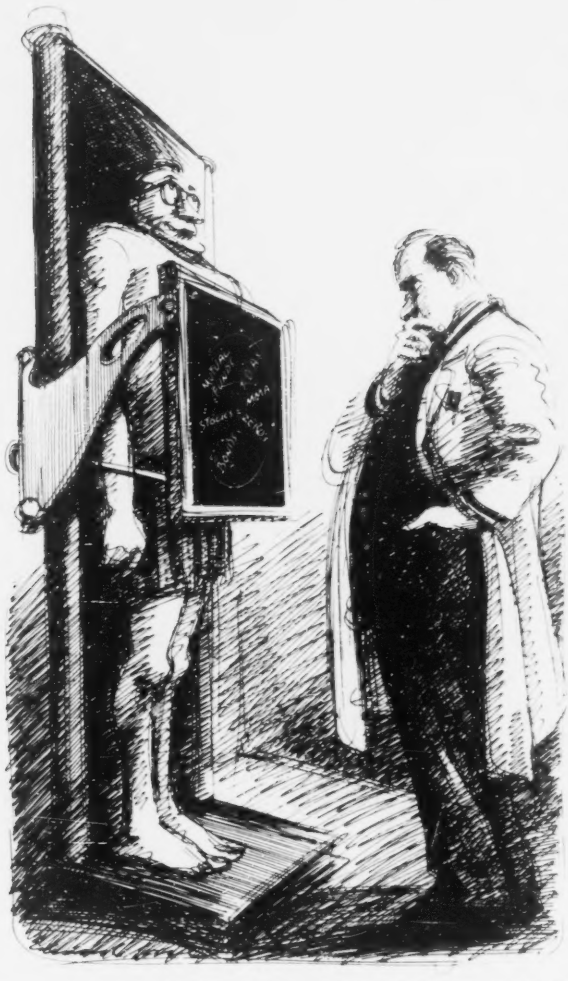


(1) Denotes wartime
(2) Implied by CBO Feb. 1986 Baseline Forecast
Sources: National Bureau of Economic Research; Congressional Budget Office

Notwithstanding these changes which may seem reasonable in light of recent developments, the fact remains that these projections, as did their predecessors, rely on continued economic growth. The economy is expected to expand at a rate of about 3½ percent per year between now and 1991, providing the revenues to help balance the budget. If the economy were to grow this long in peacetime, it would represent a most remarkable achievement. Excluding periods of war, the longest that the U.S. economy has grown nonstop was the 58 months between March 1975 and January 1980 (Chart III). Both CBO and OMB are in effect projecting a peacetime expansion of at least 109 months. To make matters even more astounding, they calculate that the economy can grow without straining available resources of both labor and capital. In other words—they do not look for inflation pressures to heat up, nor for interest rates to rise. You can see where the likelihood of this combination occurring is quite remote.

Thus, in spite of the enactment of the Gramm-Rudman Deficit Reduction Act as well as the brighter projections by CBO and OMB, the deficit outlook is still murky. Even if the Supreme Court doesn't knock the balanced budget legislation for a loop, economic trends just might. It will be most interesting to see how the Federal Reserve Board responds to these challenges in the weeks and months ahead.

How healthy is your IRA?



An IRA doesn't grow big and strong all by itself.

It needs a balanced diet.

For resistance to the chill winds of inflation and an unpredictable market, an IRA portfolio should include more than one type of investment.

So Manufacturers Hanover Trust offers time deposits, a money market account, two no-load mutual funds, stocks, bonds, and zero coupon treasuries.

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